

Cite as Det. No. 12-0345R, 33 WTD 19 (2014)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for)	<u>D E T E R M I N A T I O N</u>
Reconsideration of)	
)	No. 12-0345R
...)	
)	Registration No. . . .
)	Document No. . . .
)	Docket No. . . .
)	

WAC 458-61A-212; RCW 82.45.010: REET – EXEMPTION –
NONRECOGNITION OF GAIN OR LOSS ON ENTITY FORMATION. Where
gain is partially recognized under I.R.C. § 731(a) on the contribution of real
property to an LLC, REET applies to the amount of gain recognized as a result of
the contribution.

Headnotes are provided as a convenience for the reader and are not in any way a part of the
decision or in any way to be used in construing or interpreting this Determination.

Pree, A.L.J. – A married couple appeals real estate excise tax (REET) assessed on their transfer
of encumbered Washington real estate to their limited liability company (LLC). When the LLC
assumed the mortgage, which was larger than the couple’s adjusted basis in the property, the
gain was partially recognized for federal income tax purposes under I.R.C. § 731(a). REET
applies to the amount of the transaction for which gain was recognized under WAC 458-61A-
212 and RCW 82.45.010(3)(p)(i). Petition granted in part.¹

ISSUE

Under RCW 82.45.010(3)(p)(i) and WAC 458-61A-212, was a transfer of encumbered real
estate for a proportionate interest in an LLC subject to REET?

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

FINDINGS OF FACT

[The taxpayer] owned rental real estate (property) in . . . Washington. [In] 2010, he transferred the . . . real estate with other rental real property to a family LLC, owned by the taxpayer, his brother, and his sister.² On the REET affidavit filed when the property was transferred, the taxpayer claimed the transfer was a mere change in identity into his family LLC with no change in beneficial ownership. Consequently, he did not pay REET on the transfer.

The Special Programs Division of the Department of Revenue (Department) investigated the transfer. Special Programs found that the taxpayer owned 51% of the LLC, his brother owned 34%, and his sister owned 15% of the LLC. Special Programs concluded that there had been a 49% change in ownership of the property and assessed REET on \$. . . , which was 49% of the real estate's . . . property tax assessed value. Special Programs issued the \$. . . assessment on November 10, 2011 against the taxpayer and his wife.³ The taxpayer's appeal was denied in Det. No. 12-0345 because the taxpayer did not provide sufficient records to determine whether the transfer was exempt for federal income tax purposes. The taxpayer petitioned for reconsideration.

The taxpayer acknowledges that the transfer was not a mere change in form or identity exempt under WAC 458-61A-211, but argues that the transfer was exempt from REET under RCW 82.45.010(3)(p)(i) and WAC 458-61A-212, as a transfer when the gain was not recognized under the Internal Revenue Code (I.R.C.).

The . . . property had a property tax assessed value of \$. . . . The property was encumbered with a \$. . . loan, which the LLC assumed

On reconsideration, the taxpayer provided copies of his federal income tax returns with a worksheet that showed that the taxpayer had a \$. . . mortgage in the . . . property and a \$. . . adjusted basis in the property for federal income tax purposes at the time of the transfer. The difference, a \$. . . gain, was recognized on the taxpayer's federal income tax return, but offset by other losses, and consequently no additional tax was paid on the gain.

ANALYSIS

RCW 82.45.060 imposes the REET "upon each sale of real property" in this state. For REET purposes, a "sale" is defined as having its "ordinary meaning" and includes "any conveyance, grant, assignment, quitclaim, or transfer of the ownership of or title to real property." RCW 82.45.010(1). However, RCW 82.45.010(3)(p)(i) excludes from the definition of "sale:"

² The taxpayer filed a certificate of formation for the LLC on . . . 2006. The siblings signed the LLC operating agreement on . . . 2008 when they determined their respective interests, but did not transfer the properties until . . . 2010.

³ The assessment at issue includes [the taxpayer's] wife . . . who also signed the deed and the REET affidavit, but the taxpayer explains the real estate was inherited and his separate property.

A transfer that for federal income tax purposes does not involve the recognition of gain or loss for entity formation, liquidation or dissolution, and reorganization, including but not limited to nonrecognition of gain or loss because of application of section 332, 337, 351, 368(a)(1), 721, or 731 of the Internal Revenue Code of 1986, as amended.

WAC 458-61A-212(6) states, “In determining whether a transfer qualifies for exemption under this section, the department will consider the law, regulations, bulletins, technical memoranda, letter rulings, etc., of the Internal Revenue Code and the Internal Revenue Service, as interpreted by the courts. . . .” WAC 458-61A-212 provides the following example.

Brenda and Julie are partners in LIMA Partnership. In a nontaxable Internal Revenue Code section 721 transaction, Mike transfers real property to LIMA Partnership in exchange for a partnership interest in LIMA Partnership. No consideration, other than the partnership interest in LIMA Partnership, is given to Mike in exchange for Mike's transfer of real property. Because the transfer is exempt under Internal Revenue Code section 721, the real estate excise tax does not apply to Mike's conveyance of real property to LIMA partnership.

WAC 458-61A-212(5)(c).

RCW 82.45.010(3)(p)(i) provides that if a real estate sale qualifies as a nontaxable transaction under I.R.C. § 721, it is exempt from REET. The example in WAC 458-61A-212(5)(c) clarifies that a partner must not receive consideration (other than the partnership interest) for the transfer of real property to the partnership in order to claim the REET exemption. *See* Det. No. 09-0240, 29 WTD 58 (2010).

Here, the taxpayer argues the transfer is a nonrecognition transfer under I.R.C. § 721, which provides the general rule in subsection (a), “No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.” Treasury Regulation § 1.721-1(a), elaborates:

No gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property, including installment obligations, to the partnership in exchange for a partnership interest. This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating. . . . [I]f the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721.

Thus, if the taxpayer did not receive consideration other than an interest in the LLC for the transfer of the real property into the LLC, and the transfer is deemed as the taxpayer's capital contribution to the LLC upon its formation, there would be no gain or loss recognized under I.R.C. § 721, and the transfer would not be subject to REET under RCW 82.45.010(3)(p) and WAC 458-61A-212. *See* Det. No. 06-0289, 26 WTD 244 (2007) (where the Department

concluded that a transaction is exempt from REET when partnerships that merge with another partnership, pursuant to I.R.C. § 708, contribute, pursuant to I.R.C. § 721, ownership interests in certain apartment buildings to the other partnership in return for partnership interests in the other partnership).

However, in this case, there were substantial loans against the properties that the taxpayer transferred to the LLC. Under IRC § 752(b), decreases in a partner's share of liabilities are deemed a distribution of cash by the partnership, and to the extent they exceed basis, must be recognized under IRC § 731(a). The taxpayer's federal income tax records show the LLC assumed the \$. . . liability against the . . . property, which had an adjusted basis of \$. . . . While the taxpayer realized a larger gain of \$. . . , only to the extent the liabilities exceed basis, \$. . . , was it [recognized as gain under IRC § 731(a)]. Therefore, under IRC § 731(a), the \$. . . gain was required to be recognized.

WAC 458-61A-212(4) provides, "In the event a transaction qualifies for the exemption under this section as a nonrecognition of gain or loss transaction for entity formation, liquidation or dissolution, or reorganization, but a gain is partially recognized under the Internal Revenue Code provisions, the real estate excise tax applies to the amount of the transaction for which gain is recognized." In this case, we conclude that REET applied to \$. . . , the amount of the transaction for which gain was recognized.

DECISION AND DISPOSITION

The taxpayer's petition is granted in part and denied. The transfer at issue is not exempt from REET, but REET is imposed on the amount of gain the taxpayer recognized for federal income tax purposes.

Dated this 30th day of July, 2013.